

Global Market Watch

AUGUST 2010 | Markus Schomer, CFA, Chief Economist

Overview

- The Head of PineBridge's Asset Allocation group, Michael Kelly, called 2010 a "transition year" in one of our recent strategy meetings, implying that we are not on a sustained recovery path. Rather, we are still looking for more sustainable global growth drivers and stable fiscal and monetary-policy settings.
- Looking back, the first half of the year was clearly dominated by the "Sovereign Credit Crisis" in Europe. It appeared the "Old World" would continue to lag behind the rest of the world's developed economies, after posting mediocre growth rates in the early stage of the recovery.
- However, the situation now looks notably different. Fueled by a cheap euro, booming exports are driving the next leg of the European recovery, which now looks likely to outperform the US and Japan in the second half of the year.
- Global equity markets staged a strong rally last month, which, so far, has maintained momentum in early August. Initially a reaction to the sharp losses in May and June, equity markets remain in a bullish mode, suggesting that investors don't share the same concerns about the US growth outlook that grace newspaper headlines and dominate economist commentaries.
- Developed and emerging markets are posting very similar performance numbers since the start of July, in US dollar terms. Eastern, as well as Western, Europe and Australia are the main winners this summer, with emerging Asia and Japan lagging most notably.
- Some of the strong performance in international equities stems from a weaker dollar. The narrow US dollar index (versus 6 major currencies) has lost more than 6% since the end of June, as investors reappraise relative growth prospects around the world.
- You would think bonds would have a tougher time in the face of stronger stock markets, but both government bond yields and corporate credit spreads are rallying as well. Yields on 10-year Treasuries trended lower, even before the Fed's announcement of renewed asset purchases, and fixed income credit markets have posted strong and positive returns since the end of June.

North America

- It's not merely a forecast anymore; the second half US slowdown is here, and it actually started earlier than we had expected. In addition to disappointing payroll growth in July, the latest US Employment Report included a significant downward revision to second-quarter job growth. This new labor market reality is more consistent with the weakness in consumer spending and retail sales that we saw in May and June.
- Looking ahead, we expect private-sector payrolls to continue to expand in the second half and should add about 100,000 each month. This is not enough for a booming economy, but is sufficient to provide a solid floor for consumer spending.
- Business investment may not match its spectacular surge in the second quarter. Yet, strong profit growth and cash-heavy balance sheets suggest investment spending will continue to provide a tailwind to GDP growth. We continue to forecast sub-2% growth in the second half, followed by renewed acceleration to 2.5% in the first six months of 2011, and 3%+ in the latter half of next year.
- Despite weaker growth in its largest trading partner, the recovery in Canada continues at an above-trend

pace. Growth has likely slowed somewhat in the second quarter from the torrid rate seen in the two prior periods, but the Canadian economy will remain near the top of the developed world economies.

- Labor market conditions continue to improve, business spending has picked up notably, and additional help is coming from an unexpected direction. The Bank of Canada started the process of policy normalization in June and has raised rates twice so far. However, the last move was accompanied by a more dovish policy statement, showing growing concern over the international-growth backdrop. Hence, it is likely the bank will stand pat for the rest of the year, which in turn will reduce the risk of a more substantial currency appreciation.

Europe

- What is stirring in Europe? Only a few months ago, it seemed the eurozone could disintegrate, and many expected the fiscal austerity imposed by profligate governments all around the currency union would cause a double-dip recession within its borders. Now the euro seems far from extinction and has emerged as a savior for the old continent.

- First, it insulated the eurozone from ruinous currency volatility during the recession. Second, it helped prevent a financial collapse in countries like Greece, Ireland and Spain. And third, the depreciation versus the dollar, yen and renminbi has boosted the competitiveness of Germany's export machine. Demand from outside the eurozone is booming, and the spoils are being shared as the surge in new orders for German goods from within the eurozone demonstrates.
- Germany is well ahead in another crucial part of the recovery story, and that is job creation. After losing only about an eighth of the jobs eliminated in the US during the recession, and despite a 50% greater peak-to-through decline in GDP, more than 90% of the country's employment losses have already been erased. The rest of the eurozone is still lagging in that category, but a booming Germany will stimulate activity in the neighboring economies and raise overall eurozone growth in the second half.
- With German unemployment approaching a two-decade low, wage growth is likely to pick up, which could provide the domestic demand stimulus the eurozone needs. This leads to the next "Goldilocks" scenario: Stimulated job and wage growth in the eurozone's largest economy will, in turn, benefit the rest of the region, all while budget deficits are shrinking. This may be an overly rosy outlook, but it accentuates the risks of too much euro-bashing.

Asia

- China continues to feature prominently in our internal strategy deliberations. The economy slowed noticeably in the second quarter, after a very strong recovery last year. China only releases non-seasonally adjusted annual growth rates, but estimates for seasonally adjusted quarterly performance suggest a slowdown from about 12% in the first three months to slightly less than 7% growth in the second quarter. As a result, the government's appetite for further policy tightening has clearly cooled.
- The fact that recent inflation reports have also taken on a more constructive tone is allowing the government to stop applying the brakes and possibly even resume a moderate stimulus, if necessary. What seems off the table right now, though, is further currency appreciation, which may reignite the political tension with the US, especially in the run up to the US elections. So far, China is successfully engineering a soft landing and growth rates should

stabilize between 8% and 9% in the second half.

- The recent policy decision by the Federal Reserve to resume asset purchases and add additional stimulus to the economy may increase the pressure on the Bank of Japan to do the same. This is especially true since Japan's new Kan administration lost seats in the recent Upper House election, which makes any meaningful legislative action to stimulate the economy unlikely.
- The recovery in Japan was actually surprisingly strong so far this year, as exporters benefited from surging demand in Asia. However, low US and European interest rates have steadily strengthened the yen, which will undermine further export growth in the second half.

Investment Strategy

- The main theme in our recent strategy meetings, a summary of which is available at www.pinebridge.com, was "uncertainty." It not only applies to the second-half outlook for the US and the effect of more Fed easing, but also to the risk of policy tightening in China and the impact of the mid-term elections in the US.
- Thus, it is not surprising that we decided to stop adding risk in strategies where we only recently moved off neutral and reduce risk in portfolios where we had been running a more aggressive approach.
- If our baseline outlook is correct, and we are looking at just a temporary slowdown in the developed world, then our growth tilt towards emerging markets should deliver strong results in the medium term. However, we are facing a number of potential game changers. Hence, our more cautious near-term outlook for risk assets.

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Markus Schomer, CFA, Chief Economist for PineBridge Investments, is responsible for providing macro-economic forecasts, analysis and commentary for all PineBridge Investments groups, with a focus on global economic trends and their impact on financial markets. He holds degrees in Economics from the University of Bonn in Germany and the University of East Anglia, in the UK. He also studied at the London School of Economics and is a CFA Charterholder.

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